

INTERIM REPORT NO. 8

**REPORT ON KROLL'S BREACH OF LEGAL
DUTIES OWED TO THE CITY OF SAN DIEGO**

**REPORT OF THE
SAN DIEGO CITY ATTORNEY**

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I.

INTRODUCTION

The San Diego City Attorney is issuing this Eighth Interim Report related to alleged unlawful acts and improper activities associated with the City of San Diego's pension financial crisis. In previous Interim Reports the San Diego City Attorney has addressed the substance of the alleged illegal acts and improper activities. In this, the Eighth Interim Report the City Attorney discusses the role of Kroll Inc.

On 14 February 2005, the San Diego City Council hired former SEC Chairman Arthur Levitt to review two conflicting investigative reports addressing alleged illegal activities by San Diego City officials involving the City of San Diego's pension plan. One report was prepared by the City Attorney Michael J. Aguirre and it concluded that there was substantial evidence that members of the San Diego City Council had knowingly or recklessly violated the civil fraud provisions of federal securities laws. The other report was prepared by the City's outside counsel, Vinson & Elkins. In its report Vinson & Elkins found no wrongdoing by City Council members.

Mr. Levitt was retained, by the City through Kroll, Inc., ("Kroll"), a risk management firm. Mr. Levitt created a three member team consisting of himself, former SEC accountant Lynn Turner, and attorney Troy Dahlberg.

Mr. Levitt's charge was to reconcile separate investigative reports into alleged illegal acts by City officials involving the City's pension plan and other financial disclosure practices. The engagement was intended to satisfy KPMG, the City's outside auditor that an appropriate "illegal acts" investigation was conducted by the City in conformance with the applicable auditing standards.

In this report the City Attorney now concludes that Kroll and its partner Willkie Farr & Gallagher LLP ("Willkie Farr") have breached legal duties they owed to the City of San Diego ("City"). Kroll and Willkie Farr's breach of legal duties owed to the City of San Diego has been the proximate cause of substantial damages suffered by the City of San Diego.

In this report the City Attorney documents that Kroll and Willkie Farr have:

- Breached contractual and professional duties to the City of San Diego, by failing to perform or performing below the applicable standard of care;
- Failed to complete their work specified deadlines;
- Expanded the scope and cost of their work without Council authorization;
- Violated City billing guidelines by failing to support their billings with proper documentation;
- Failed to act independently;
- In the case of Kroll, engaged in unauthorized lobbying activities; and
- Used undue influence to pressure the City to pay the firms over \$20 million.

It is the recommendation of the City Attorney's Office that the City of San Diego immediately terminate its engagement with Kroll and Willkie Farr and that it initiate litigation to recover financial losses to the City.

II.

BACKGROUND

The City of San Diego is in the throes of one of the most daunting political and financial crises in its history. The City is currently facing a pension funding deficit of between \$1.4 billion and \$2 billion in its pension system as a result of a number of financial factors including, but not limited to, the creation of illegal retirement benefits.

The granting of these benefits is the result of two contingent, quid pro quo arrangements between the San Diego City Council and the San Diego City Employees' Retirement System (SDCERS). The potential magnitude of the pension debt, or unfunded liability, was discovered in late 2001 and information about the growing nature of the shortfall was communicated to SDCERS and some City officials but hidden from the public.¹

¹ 3 December 2001 E-mail from Assistant City Auditor and SDCERS Board Trustee Teri Webster to SDCERS Administrator Lawrence Grissom and carbon-copied to City Human

The City filed voluntary corrections to its Certified Annual Financial Report (“CAFR”) disclosures on 27 January 2004 calling attention to debts that were omitted from previously released financial disclosures.² Meanwhile the City has not issued a Comprehensive Annual Financial Report (CAFR), or audit, since fiscal year 2002. The lack of a financial audit has prevented the City from borrowing money in the public markets.

The filing of the voluntary disclosures raised concerns with the U.S. Securities and Exchange Commission (“SEC”) and the U.S. Attorney’s Office (“U.S. Attorney”). Both federal agencies launched investigations of the City. The SEC and the U.S. Attorney issued document requests to the City in July 2004.

The City retained Houston-based law firm Vinson & Elkins L.L.P. (“Vinson & Elkins”) on 18 February 2004 to undertake an inquiry into the City’s financial disclosure practices.³ The firm was to investigate the City’s financial control structure to identify any misconduct and practices that allowed the disclosure failures to occur.

Vinson & Elkins was tasked with working with accounting firm KPMG to examine the old financial data, ensure that all issues related to receiving an unqualified audit were addressed and to identify and implement policies to ensure the errors do not occur in the future. Both Vinson & Elkins and KPMG failed to agree on a work plan sufficient to satisfy applicable audit requirements.

After discovering a series of errors by the auditing firm Caporicci & Larson on the 2002 CAFR, the City severed the business relationship with that firm. Although Caporicci & Larson had completed an audit for fiscal year 2003, the City hired KPMG to, in effect, re-do the 2003 audit.⁴ KPMG

Resources Director and SDCERS Board Trustee Cathy Lexin. Re: earnings EEEK!
(Exhibit 1)

² Municipal Secondary Market Disclosure (Exhibit 2)

³ 18 February 2004 letter from Vinson & Elkins Partner Paul S. Maco to former City Attorney Casey Gwinn. (Exhibit 3)

⁴ 13 April 2004 letter from KPMG Partner Steven DeVetter to Lisa Irvine, director of the City’s Financial Management Department. (Exhibit 4)

issued a letter to the City on 9 August 2004 stating that the investigation being performed by Vinson & Elkins must include an analysis of whether any laws were violated.⁵

In the 9 August 2004 letter, KPMG Partner Steven DeVetter specifically asked Vinson & Elkins to answer a series of questions that included, “Did the SDCERS Board breach their fiduciary duty by allowing the City to underfund the plan in exchange for additional benefits for current employees and could this action have been in violation of any laws?...Did the City violate the City Charter by failing to fund its retirement plan as required by the City Charter?...Did the SDCERS Board and/or the City violate the California Constitution by allowing the City to intentionally underfund the plan?” KPMG also included a copy of the American Institute of Certified Public Accountants AU § 317.⁶

Vinson & Elkins issued their report titled “Report on Investigation: The City of San Diego, California’s Disclosures of Obligation to Fund the San Diego City Employees’ Retirement System and Related Disclosure Practices,” on 16 September 2004.⁷ The report outlined two different agreements between the City Council and the SDCERS Board of Administrations (“Board”) as the primary sources of the pension deficit.

These agreements provided for the SDCERS Board to accept underfunding of the retirement system in exchange for the City Council agreement to grant enhanced unfunded pension benefits for City employees. The first deal, commonly referred to as Manager’s Proposal I, was approved in 1996. The second deal, called Manager’s Proposal II, was approved in 2002. The report found that a series of disclosure violations occurred. The report, however, made no mention of any individual violations of law by

⁵ 9 August 2004 letter from KPMG Partner Steven DeVetter to Assistant City Attorney Les Girard. Re: Investigation. (Exhibit 5)

⁶ American Institute of Certified Public Accountants AU § 317. Illegal Acts by Clients (Exhibit 6)

⁷ 16 September 2004. Vinson & Elkins: Report on Investigations. The City of San Diego, California’s Disclosures of Obligations to Fund the San Diego City Employees’ Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code. (Exhibit 7)

City or SDCERS officials. In fact, no assessment of potentially illegal acts was made by Vinson & Elkins during its investigation.

KPMG issued a letter to the City on 11 October 2004 which stated that the report was insufficient to meet professional auditing standards and that an illegal acts analysis was necessary for the audit to be completed. DeVetter wrote,

[W]e do not believe that the City of San Diego (“City”) has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken. Such an investigation is necessary in order for an auditor to complete an audit in accordance with generally accepted auditing standards and *Government Auditing Standards*.⁸

Importantly, the letter quoted additional language from the American Institute of Certified Public Accountants regarding auditing standards. The language was meant to serve as a guideline for a future investigation.

Vinson & Elkins Partner Paul Maco issued a response to Assistant City Attorney Leslie Girard on 28 October 2004, stating that KPMG “fail[ed] to provide any practical guidance as to what additional investigative procedures [KPMG] would find satisfactory” for the completion of the 16 September 2004 report.⁹

KPMG reasserted the need for an illegal acts investigation in a 29 October 2004 letter to former Mayor Dick Murphy.¹⁰ DeVetter, in the letter, explicitly asked the City to contract a firm other than Vinson & Elkins to complete this work.

⁸ 11 October 2004. Letter from Steven G. DeVetter to Leslie J. Girard. Re: City of San Diego Fiscal Year 2003 Audit (Exhibit 8)

⁹ 28 October 2004. Letter from Vinson & Elkins Partner Paul Maco to Assistant City Attorney Leslie Girard. Re: Additional Investigation. (Exhibit 9)

¹⁰ 29 October 2004. Letter from KPMG Partner Steven DeVetter to Assistant City Attorney Leslie Girard. Re: Follow-up from meeting on August 27, 2004. (Exhibit 10)

“If the City is prepared to proceed with an appropriate investigation, then we urge you to consider retaining counsel other than V&E [Vinson & Elkins] to do so. The positions asserted in, and oppositional tone of, Mr. Maco’s letter raises questions about V&E’s willingness or ability in these circumstances to complete the investigation of, and reach conclusion on, the audit-critical questions posed in our prior oral and written communications and to do so with an objective and independent manner.”¹¹

Despite the specific request, the City extended the contract with Vinson & Elkins to complete the investigation and to provide its analysis in a second report.

A new City Attorney, Michael J. Aguirre, was elected on 2 November 2004 and took office on 6 December 2004. The new City Attorney announced the City Attorney’s Office would conduct an independent illegal acts investigation under applicable auditing standards.¹² The City Attorney subsequently released a series of Interim Reports outlining alleged illegal acts that occurred in the approval of the Manager’s Proposal I in 1996 and Manager’s Proposal II in 2002. The first Interim Report was issued on 14 January 2005¹³ and the second Interim Report was issued on 9 February 2005.¹⁴

The City Council then hired Los Angeles-based forensic accounting firm, Kroll Inc., to sort out the findings of Vinson & Elkins and the City Attorney. Troy Dahlberg, managing director of Kroll, issued a letter of

¹¹ 29 October 2004. Letter from KPMG Partner Steven DeVetter to Assistant City Attorney Leslie Girard. Re: Follow-up from meeting on August 27, 2004. (Exhibit 10)

¹² 9 December 2004. Press release from the office of City Attorney Michael Aguirre. “Statement from City Attorney Michael J. Aguirre: Financial Disclosure Practices Investigation, and Decision Not to Join San Diego’s Retirement System.” (Exhibit 11)

¹³ 14 January 2005. Interim Report No. 1 Regarding Possible Abuse, Fraud, and Illegal Acts by San Diego City Officials and Employees. Report of the San Diego City Attorney Michael J. Aguirre. (Exhibit 12)

¹⁴ 9 February 2005. Interim Report No. 2 Regarding Possible Abuse, Fraud, and Illegal Acts by San Diego City Officials and Employees. Report of the San Diego City Attorney Michael J. Aguirre. (Exhibit 13)

engagement to the City on 10 February 2005. The Kroll scope of services were stated as follows:

“The City has requested that Kroll (1) receive, review and evaluate the findings of the investigations by VINSON & ELKINS and the City Attorney. The City has also requested Kroll provide consulting assistance in assessing internal control deficiencies affecting matters discussed in the investigation reports.”¹⁵

The letter also conditions the performance of Kroll’s responsibilities intended to satisfy the needs of KPMG. Kroll specifically requested unfettered access to personnel and documents of the City, SDCERS, Vinson & Elkins, the City Attorney, and other potentially involved parties.¹⁶ Kroll also retained the authority to hire legal counsel for representation at the City’s expense. The City Council approved the Kroll contract at its 14 February 2005 meeting.¹⁷

The Kroll team is headed up by Troy Dahlberg who is billed at \$450 an hour, Lynn Turner at \$750 an hour, and Arthur Levitt at \$900 an hour. The remainder of the Kroll associates working on the project bill at rates ranging from \$125 to \$750 per hour.¹⁸ At the 14 February 2005 televised City Council meeting, Lynn Turner, a consultant for Kroll, explained that Kroll would take the reports issued by the City Attorney and Vinson & Elkins, compare the data and findings, and issue its findings to KPMG.¹⁹

¹⁵ 10 February 2005. Letter from Troy Dahlberg to Mayor Richard Murphy and San Diego City Council. Re: Independent Services for the City of San Diego. (Exhibit 14)

¹⁶ 10 February 2005 letter from Troy Dahlberg, managing director of Kroll, to Mayor Richard Murphy and San Diego City Council. Re: Independent Services for the City of San Diego. (Exhibit 14)

¹⁷ 14 February 2005 meeting of the San Diego City Council. (Exhibit 15)

¹⁸ 10 February 2005 letter from Troy Dahlberg to Mayor Richard Murphy and San Diego City Council. Re: Independent Services for the City of San Diego. P 4. (Exhibit 14)

¹⁹ Transcript of Lynn Turner’s presentation at the 14 February 2005 meeting of the San Diego City Council. (Exhibit 16)

Kroll also outlined a second phase of their work: consulting with City personnel to establish internal controls to ensure that financial transactions are identified and reported properly in financial reports issued by the City. Kroll stated that this part of their engagement with the City would begin upon completion of its analysis of the work of Vinson & Elkins and the City Attorney.

Turner appeared again at the televised City Council meeting on 8 March 2005. At the meeting the City Council authorized representatives of Kroll to establish "the Audit Committee of the City as contemplated by the Sarbanes-Oxley Act of 2002" as discussed below.²⁰ The majority of City Council members at the meeting also agreed to sign a letter to cease discussing investigative matters with the press. Council member Donna Frye and City Attorney Michael J. Aguirre declined to sign the letter. Kroll later brought on the law firm of Willkie Farr & Gallagher ("Willie Farr") to work with Kroll.²¹

III.

AUDIT COMMITTEE DUTIES

The format and function of an Audit Committee for a municipality has been laid out and identified by the Government Finance Officers Association (GFOA), a professional association of state/provincial and local finance officers in the United States and Canada, and has served the public finance profession since 1906. In applying the standards and practices, the GFOA utilizes accounting and disclosure standards applied to private corporate business in the Sarbanes-Oxley Act of 2002.

The GFOA specifies that three groups are principally responsible for the financial reporting of a municipal body: "the governing body, financial

²⁰ 8 March 2005 meeting minutes of the San Diego City Council. Resolution Number R-300203 (Exhibit 17)

²¹ 19 April 2005 letter from Willkie Farr & Gallagher to Kroll Inc. Re: Terms of Engagement as Counsel to the Audit Committee of the City of San Diego. (Exhibit 18)

management, and the independent auditors.”²² The GFOA states that the governing body must maintain its ability to oversee the process.

“Of these three, the governing body must be seen as ‘first among equals’ because of its unique position as the ultimate monitor of the financial reporting process.”

The GFOA states that the governing body:

“[I]nclude any other elected officials (e.g., county auditor, city controller) with legal responsibility for overseeing financial reporting, internal control, and auditing, provided they do *not* exercise managerial responsibilities within the scope of the audit. The term ‘governing body’ also is intended to encompass appointed bodies such as pension boards.”

The GFOA goes on to state that the members of an audit committee “should be members of the governing body. To ensure the committee’s independence and effectiveness, no governing body member who exercises managerial responsibilities that fall within the scope of the audit should serve as a member of the audit committee.”

Once established by the governing body of a municipality, the purpose of the Audit Committee is to provide independent oversight of the completion of a CAFR to ensure that accurate information is disclosed in financial reports. The audit committee should submit one written report annually to the governing body. The GFOA states:

The audit committee should present annually to the full governing body a written report of how it has discharged its duties and met its responsibilities. It is further recommended that this report be made public and be accompanied by the audit committee’s charter or other establishing documentation.²³

²² Government Finance Officers Association. “Recommended Practices: Audit Committees (1997, 2002, and 2006) (CAAFR). (Exhibit 106)

²³ Government Finance Officers Association. “Recommended Practices: Audit Committees (1997, 2002, and 2006) (CAAFR) (Exhibit 106)

This interim report will illustrate that the formation of the audit committee is not in compliance with standards set for by the GFOA. The evidence presented below will also show that Kroll and Willkie Farr have failed to complete their responsibilities in acting as an audit committee as prescribed by the GFOA.

IV.

KROLL HAS BREACHED LEGAL DUTIES

As stated above, Kroll was hired by the City of San Diego to conduct an independent comparison and evaluation of the reports issued by the City Attorney and Vinson & Elkins.

Almost immediately, Kroll and Vinson & Elkins began working together. On 6 May 2005, Kroll issued a letter to City Manager P. Lamont Ewell explaining that materials compiled by Vinson & Elkins in the course of its investigations were useful. The letter was vague, however, as to whether Vinson & Elkins would issue a second report. In the letter, Kroll continued to stress their independence despite working with Vinson & Elkins.²⁴

Questions have been raised as to whether or not Vinson & Elkins' work program will result in another report from that firm. The independent auditors have not specifically requested that from the Audit Committee.²⁵

At this point, the duties of Kroll appeared to have changed from analyzing a series of reports from Vinson & Elkins and the City Attorney to conducting another investigation and issuing a completely separate report. There were, however, no amendments made to the Kroll contract to reflect the revised scope of work at that time. It is also important to note that the letter illustrates that Kroll appeared to be managing the work of Vinson & Elkins – a significant departure from Kroll's contractual obligation to analyze Vinson & Elkins final investigative product.

²⁴ 6 May 2005 letter from Troy Dahlberg, managing director of Kroll Inc., to City Manager P. Lamont Ewell. Re: Audit Committee – Investigation Status. (Exhibit 19)

²⁵ 6 May 2005 letter from Troy Dahlberg, managing director of Kroll Inc., to City Manager P. Lamont Ewell. Re: Audit Committee – Investigation Status. (Exhibit 19)

Kroll sent a letter to the City Council on 10 June 2005 further outlining its relationship with Vinson & Elkins.²⁶ Dahlberg wrote that the Kroll team had been reviewing the work plan laid out by Vinson & Elkins, examining documents collected, and would “provide V&E guidance as to the structure and format for presenting their findings and work product to KPMG.” The letter also stated that Vinson & Elkins will issue a “summary memorandum” which will serve as a second report.²⁷

Kroll also unilaterally elected to assert control over the production of documents in response to a series of subpoenas issued by the U.S. Attorney’s Office and the SEC.²⁸ Working in conjunction with Kroll, the Mayor and City Manager issued a memo on 10 June 2005 requesting documents from thousands of employees across the City bureaucracy. Over the next few months, a monumental effort by City staff – many of whom were not involved in the matter under investigation or who were not employed by the City at the time of the events – produced more than one million paper documents.²⁹

Representatives of Kroll appeared before the City Council on 14 June 2005 to provide a status report on their work. At the meeting, Mr. Levitt said that the work was being delayed because the SDCERS Board of Directors had failed to waive the attorney-client privilege on documents Kroll needed to complete their investigation.³⁰

Meanwhile, concerns were growing in the City about the scope of documents that were requested by Kroll and the Mayor and City Manager’s

²⁶ 10 June 2005 letter from Troy Dahlberg, managing director at Kroll, to Mayor Richard Murphy. Re: Audit Committee – Investigation Status Update. (Exhibit 20)

²⁷ 10 June 2005 letter from Troy Dahlberg, managing director at Kroll, to Mayor Richard Murphy. Re: Audit Committee – Investigation Status Update. (Exhibit 20)

²⁸ 10 June 2005 letter from Troy Dahlberg, managing director at Kroll, to Mayor Richard Murphy. Re: Audit Committee – Investigation Status Update. (Exhibit 20)

²⁹ 10 June 2005 memo from Mayor Richard Murphy and City Manager P. Lamont Ewell to all City employees, City Council, and San Diego City Retirement System. (Exhibit 21)

³⁰ Transcript of Arthur Levitt’s testimony at the 14 June 2005 meeting of the San Diego City Council. (Exhibit 22)

letter of 10 June 2005. The City's Chief Information Officer, Rey Arellano, addressed that anxiety in a letter to Lynn Turner on 23 June 2005.³¹ Arellano wrote,

The questions generally surround the specific process to be used to conduct a search of electronic files and e-mail, whether search terms will be provided, why every City employee regardless of how far removed they may be from any of the issues needs to respond, and various questions specific to some departments' unique circumstances.³²

Kroll, however, did not pare down the request to City employees and continued to collect boxes of documents – many of which had already been collected in response to subpoenas from federal investigators.

On 1 August 2005, Troy Dahlberg appeared back before the televised City Council meeting to request the Council waive the attorney privilege on documents that Vinson & Elkins obtained during its investigation. During Dahlberg's presentation, Councilmember Donna Frye asked a series of questions about the documents that were being waived and to whom they would be presented. Dahlberg said that the information was going to be presented to the SEC and KPMG.

In response to council member Frye's questions, Dahlberg also stated that Kroll possessed in its ninth floor City Hall office a memorandum from Vinson & Elkins explaining the findings of their second investigation.³³ Both Frye and the City Attorney criticized the firms for not alerting the City Council to the existence of the draft Vinson & Elkins memorandum and requested a copy. Dahlberg reluctantly provided a copy of the 116-page report to the Council and City Attorney.³⁴ The memorandum, released to the

³¹ 23 June 2005 letter from Rey Arellano, chief information officer for the City of San Diego to Lynn Turner. (Exhibit 19)

³² 23 June 2005 letter from Rey Arellano, chief information officer for the City of San Diego to Lynn Turner. (Exhibit 23)

³³ Transcript of the 1 August 2005 meeting of the San Diego City Council. (Exhibit 24)

³⁴ Vinson & Elkins draft report titled "Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals". 15 July 2005 (Exhibit 25)

public in the following days, found that the City failed to adhere to Generally Accepted Accounting Principles (“GAAP”). The report, however, cited no intentional wrongdoing or violations of law.

By this time, the City Attorney had released six Interim Reports outlining alleged illegal acts surrounding Manager’s Proposal I and II. The six reports contained footnotes and evidence to substantiate each claim and contained extensive appendices containing all footnoted documents.

Kroll now had the essential materials necessary to complete the work detailed in its 10 February 2005 engagement letter with the City. To date, no such work product has been produced. Kroll’s failure to compare the two reports and report its findings to KPMG represents a breach in the firm’s contractual responsibility to the City. As a result of this failure, KPMG has not issued its 2003 audit opinion and the City still cannot access the public capital markets.

Instead, Kroll continued to claim that the City Attorney had not been responsive in turning over relevant documents and methods used in the research and writing of the six Interim Reports. Dahlberg stressed this issue in status update letters to the City Council on 6 May 2005 and 10 June 2005.

On 5 August 2005, the City Attorney issued a 41-page letter listing every document included in the Interim Reports.³⁵ The letter stated that the relevant documents for the investigation were disclosed when the reports were issued and invited representatives of Kroll and Willkie Farr to identify any further needs.

Kroll and a team of attorneys from Willkie Farr appeared before the City Council on 9 August 2005 to present another status report on the progress of their work. Levitt told the Council that the investigation could not be completed without the waiver of the attorney client privilege from SDCERS. Levitt said,

In just five months of work, we have encountered a refusal by the pension board to make available to the U.S. Attorney, the SEC, or the Audit Committee documents critical to the

³⁵ 5 August 2005 letter from City Attorney Michael Aguirre to Troy Dahlberg, managing director of Kroll Inc. Re: Audit Committee of the City of San Diego. (Exhibit 26)

ascertainment of the truth and critical to the completion of an investigation satisfactory to both us and the auditor.³⁶

Levitt added that he anticipated Kroll's investigation would be completed by the end of calendar year 2005. At that meeting Levitt again claimed that all documents had not been turned over by the City Attorney. However, when asked by the City Attorney if Levitt and Dahlberg had examined the reports and the supporting documents, both said they had not reviewed all the material to ensure that all relevant information had been provided.³⁷

Later in August 2005, a federal court ordered SDCERS to release more than 60,000 documents that had been protected by the attorney-client privilege.³⁸ Numerous documents were discovered that corroborated the assertion that a quid pro quo arrangement took place between the City and SDCERS in the approval of Manager's Proposal II in 2002. This information was widely reported by broadcast and print media organizations.

On 15 September 2005 the City Attorney issued an Interim Report focusing on illegal acts in sewer rate overcharges. The report concluded that, "there is substantial evidence consistent with a finding that City officials did attempt to conceal, and did conceal, material information regarding the wastewater system's noncompliant rate structure and the potential risk of forfeiture of Federal grants and State loans."³⁹

Representatives of Kroll and Willkie Farr again appeared before the City Council on 26 September 2005 to provide another status report. Benito Romano, a Willkie Farr partner in charge of that firm's engagement, said that the new documents from SDCERS and an additional 20 to 30 boxes of

³⁶ Transcription of Arthur Levitt's comments at the 9 August 2005 meeting of the San Diego City Council. (Exhibit 27)

³⁷ Transcription of the 9 August 2005 meeting of the San Diego City Council. (Exhibit 28)

³⁸ Donohue, Andrew. "Pension Documents to Be Turned Over to Feds". *Voice of San Diego*. 23 August 2005. (Exhibit 29)

³⁹ 15 September 2005. "Wastewater Interim Report No. 1: City of San Diego Officials' Failure to Disclose Material Facts in Connection With The Offer and Sale of Wastewater Bonds and Related Improper Activity." (Exhibit 30)

documents from City Council members all needed to be properly analyzed before Kroll and Willkie Farr could complete their work.

Romano also said that the staff of the SEC asked Kroll and Willkie Farr to look into possible illegal acts concerning sewer rate overcharges paid by residents of the City. He said, “We are giving the SEC our unvarnished views about whatever the evidence shows, as we would in the pension area.” Romano said that the work would be completed by the end of the 2005 calendar year.⁴⁰

Members of Kroll and Willkie Farr met with representatives of the City Attorney’s office on 21 September 2005 to discuss the investigation. At the meeting, Romano and Dahlberg stated that work on a draft of Kroll and Willkie Farr’s investigative report would commence soon. On 4 October 2005, Assistant City Attorney Anita Noone wrote a letter to representatives of Kroll and Willkie Farr to request notification when the draft had begun.⁴¹ A reply from representatives of Kroll and Willkie Farr was never received.

On 25 October 2005, Dahlberg sent a letter to notify the City that the investigation and report would not be completed until mid-March due to a series of new problems.⁴² The letter stated that more documents had been produced by City employees in response to the 10 June 2005 request letter than was anticipated. The letter stated, “City Employees provided approximately 400 boxes of documents in response to the 10 June 2005 memo.

The volume of records is far greater than what was initially expected. Review of this information will require more time than was previously anticipated.”⁴³ In effect, Kroll and Willkie Farr ignored the plea from

⁴⁰ Transcription of Benito Romano’s testimony at the 9 August 2005 meeting of the San Diego City Council. (Exhibit 31)

⁴¹ 4 October 2005. Letter from Assistant City Attorney Anita Noone to Benito Romano and Jeffery Klein. Carbon-copied to Troy Dahlberg, Lynn Turner, and Michael Aguirre. (Exhibit 32)

⁴² 25 October 2005 letter from Arthur Levitt, Lynn Turner, and Troy Dahlberg to Acting Mayor Toni Atkins. Re: Audit Committee – Investigation Status Update. (Exhibit 33)

⁴³ 25 October 2005 letter from Arthur Levitt, Lynn Turner, and Troy Dahlberg to Acting Mayor Toni Atkins. Re: Audit Committee – Investigation Status Update. (Exhibit 33)

Arellano to pare down the scope of the document request, and then claimed that the resulting volume would delay the completion of the report.

The letter also stated that numerous problems had arisen from a computer program that Vinson & Elkins had used to catalogue documents in a database. As a result, Kroll and Willkie Farr would need to hire more consultants to fix this problem and create a second electronic database to store documents.⁴⁴

Representatives of Kroll and Willkie Farr appeared before the televised City Council meeting on 1 November 2005 and received additional funding for its work and for the work of consultants to analyze and build the new database.⁴⁵ At this point in November 2005, Kroll had worked for 8 months and, to the knowledge of the City Attorney, delivered no report of its findings to the City.

On 6 January 2006 the U.S. Attorney's Office announced its indictments of three former trustees of the San Diego City Employee's Retirement System: Ron Saathoff, president of the San Diego Firefighters Association Local 145; Cathy Lexin, former Human Resources Director for the City; and Terri Webster, former assistant auditor and comptroller for the City. The indictments also named former SDCERS Administrator Lawrence Grissom, and Lorraine Chapin, general counsel at SDCERS.⁴⁶

In a local newspaper, Dahlberg told a reporter that the action by the U.S. Attorney would lead to another expansion of the scope of Kroll's

⁴⁴ 25 October 2005 letter from Arthur Levitt, Lynn Turner, and Troy Dahlberg to Acting Mayor Toni Atkins. Re: Audit Committee – Investigation Status Update. (Exhibit 33)

⁴⁵ 1 November 2005 meeting minutes of the San Diego City Council. (Exhibit 34)

⁴⁶ 6 January 2006. United States District Court Southern District of California January 2004 Grand Jury: United States of America, Plaintiff, v. Ronald Saathoff (1), Cathy Lexin (2), Teresa Webster (3), Lawrence Grissom (4), Lorraine Chapin (5), Defendants. Criminal Case No. 06CR0043BEN. Indictment: Title 18, U.S.C., Sec. 371 – Conspiracy to Commit Wire and Mail Fraud; Title 18, U.S.C., Secs. 1343 and 1346 – Wire Fraud; Title 18, U.S.C., Secs. 1341 and 1346 – Mail Fraud; Title 18, U.S.C., Sec. 2 – Aiding and Abetting. (Exhibit 35)

investigation.⁴⁷ According to the media report, Dahlberg said that grand jury allegations must be reviewed, but that Kroll and Willkie Farr would not have access to the interviews conducted by federal investigators.

Dahlberg said, “We are not privy to the evidence that's gathered by any of the governmental agencies...It's on our shoulders to go out and do our own investigation.”⁴⁸ Dahlberg also added that Kroll had not received all of the e-mails from Chapin and Grissom from SDCERS despite the organization's waiver of the attorney client privilege, according to the report.⁴⁹

Soon thereafter, Kroll leaked information to the press that more money would be needed to complete its investigation.⁵⁰ In a 20 December 2005 report in the *Voice of San Diego*, Dahlberg said that Kroll would need an additional \$9 million to \$11 million to finish the investigation. Dahlberg said that the City Council allowed the company to spend money as it saw fit under the auspices of the Sarbanes-Oxley Act. Dahlberg was quoted in the report saying, “We wanted that empowerment so that they wouldn't interfere with the investigation improperly.”⁵¹ The Dahlberg estimate would prove to be too low.

Lynn Turner issued a letter to Mayor Jerry Sanders and the City Council on 13 January 2006 stating that the “professional fees for services yet incurred, to complete the remaining work necessary for the investigation and issuance of our work are in the range of approximately \$7 million to \$10

⁴⁷ Hall, Matthew T. “City's financial picture worse than ever, Sanders says.” *San Diego Union-Tribune*. 7 January 2006. (Exhibit 36)

⁴⁸ Hall, Matthew T. “City's financial picture worse than ever, Sanders says.” *San Diego Union-Tribune*. 7 January 2006. (Exhibit 36)

⁴⁹ Hall, Matthew T. “City's financial picture worse than ever, Sanders says.” *San Diego Union-Tribune*. 7 January 2006. (Exhibit 36)

⁵⁰ Donohue, Andrew. “Not Requesting, Insisting.” *Voice of San Diego*. 20 December 2005. (Exhibit 37)

⁵¹ Donohue, Andrew. “Not Requesting, Insisting.” *Voice of San Diego*. 20 December 2005. (Exhibit 37)

million.”⁵² Turner added, “In addition, the draft resolution notes there is also approximately \$3.3 million in billed and unbilled services that have not been paid at this time.”⁵³

Turner concluded in his 13 January 2006 letter with what appeared to be a veiled threat, “If the Council determines not to approve the funding, we assume that will be consistent with a decision not to complete the investigation. Of course, the City’s cooperation in completing the work that needs to be done is important.”⁵⁴ At the televised San Diego City Council meeting of 17 January 2006, the City Council approved an allocation of \$10 million to Kroll for the completion of the study.⁵⁵

Just two weeks later, the leadership of Kroll and Willkie Farr issued a letter to Mayor Jerry Sanders and Council member Scott Peters on 25 January 2006 requesting an additional \$3.2 million. Dahlberg wrote in the letter that, without the funding the investigation will not be completed.⁵⁶ Dahlberg wrote:

We understand the City Council authorized an expenditure of up to \$10 million for the Audit Committee to complete its work, which, as we have noted repeatedly, is an important step in obtaining audited financial statements, restoring the City’s Audit rating and facilitating cooperation with law enforcement. The Audit Committee will do everything it can to complete the investigation in an efficient and timely manner, consistent with its independence and obligation to be thorough. Be advised, however, the authorized level of funding, based on our present

⁵² 13 January 2006. Letter from Lynn Turner to Mayor Jerry Sanders and Council member Scott Peters. Re: Audit Committee Investigation. (Exhibit 38)

⁵³ 13 January 2006. Letter from Lynn Turner to Mayor Jerry Sanders and Council member Scott Peters. Re: Audit Committee Investigation. (Exhibit 38)

⁵⁴ 13 January 2006. Letter from Lynn Turner to Mayor Jerry Sanders and Council member Scott Peters. Re: Audit Committee Investigation. (Exhibit 38)

⁵⁵ 17 January 2006 minutes for regular meeting of the San Diego City Council. (Exhibit 39)

⁵⁶ 25 January 2006. Letter from Troy Dahlberg to Mayor Jerry Sanders and Council member Scott Peters. (Exhibit 40)

best estimate, will very likely fall short of the funding required to complete the investigation by as much as approximately \$3.3 million.⁵⁷

The letter did not indicate what work remained to be completed in the investigation and importantly provides no time line as to when the work would be completed.

Kroll and Willkie Farr have not completed their report comparing the work of Vinson & Elkins and the City Attorney. Kroll and Willkie Farr have also failed to complete their investigation or provide a timeline for its completion. The City Attorney finds the failure to complete the comparison of the Vinson & Elkins and the City Attorney's reports to be a breach of contract with the City of San Diego.

The City Attorney issued a seventh Interim Report on 6 December 2005 analyzing the documents released by SDCERS.⁵⁸ The report concluded that the SDCERS documents "provides additional evidence that retirement benefits granted by the City Council as part of Manager's Proposal II was part of a quid pro quo arrangement to entice the SDCERS Board to lower the 82.3 percent funding trigger." The report also concluded there is "substantial evidence that officials and trustees of SDCERS violated Government Code 1090 and there is also evidence these officers violated their fiduciary duty to the pension system."

V.

KROLL INVOICES BREACHED INTERNAL CONTROLS

The American Institute of Certified Public Accountants (AICPA) outlines auditing and professional standards in their Codification of Statements on Auditing Standards. Specifically, AU § 319 specifies the roles and responsibilities of the hiring agency. That section also establishes the standards and a professional code of conduct of auditors and accountants.

⁵⁷ 25 January 2006. Letter from Troy Dahlberg to Mayor Jerry Sanders and Council member Scott Peters. (Exhibit 40)

⁵⁸ 6 December 2005. Interim Report No. 7 – SDCERS Attorney-Client Privilege Documents Released Under Federal Court Order – Report of San Diego City Attorney Michael J. Aguirre. (Exhibit 41)

The City and the consultant are required to ensure that work is being done properly by instituting information and communication standards, and control processes to ensure efficient and quality work.⁵⁹

The City of San Diego maintains guidelines for billing by outside consultants and contractors. Specifically, City of San Diego Administrative Regulations state that all consulting agencies that contract with the City must:

[E]xpressly warrant that the work is based upon its expertise and shall be done in accordance with good (audit, professional, etc.) practices. Where approval by the City, or representatives of the City is indicated, it is understood to be conceptual approval only and does not relieve the consultant of responsibility for complying with all laws, codes and good (audit, professional, etc.) practices.⁶⁰

The San Diego City Attorney's Office has established a set of internal controls to be used when reviewing attorney and consultant billings. The City Attorney uses specific billing guidelines that require detailed billing. The guidelines require that the invoice shall be accompanied by a separate invoice briefly describing each task performed, the time spent on the task, the identity of the person who performed the work, and itemized reimbursable expenses.⁶¹

Kroll and Willkie Farr have sent more than 10 invoices to the City of San Diego without providing sufficient detail of the work performed. The lack of accurate billing has rendered the City unable to properly monitor the engagements.

Kroll sent eight invoices to the City between the time it was hired on 14 February 2005 and the first update to the City Council on 14 June 2005.

⁵⁹ American Institute of Certified Public Accountants' handbook titled "Codification of Statements on Auditing Standards. Section: "AU § 319 – Consideration of Internal Control in a Financial Statement Audit." (Exhibit 42)

⁶⁰ City of San Diego Administrative Regulation. Appendix B-1. A Consultant is an Independent Contractor. (Exhibit 43)

⁶¹ San Diego City Attorney's Office Billing Guidelines for Outside Counsel. (Exhibit 44)

The total charge for those eight invoices was \$1,207,549.⁶² The bills were broken down among three classifications: “Internal Investigations,” “Research Pension Board Nominees,” and “For Professional Services Rendered.”⁶³ The bills include the names of more than 20 individuals, each billing for a specific numbers of hours at rates ranging from \$85 to \$950 per hour. The bills do not include any information about what tasks each individual performed.

Willkie Farr submitted its first bill to the City on 17 May 2005, for a sum of \$25,406.⁶⁴ The bill included a breakdown of services, in half-hour increments and the initials of the employee working on the task. The descriptions on the billing included items such as “review reports and correspondence” and “Begin reading Luce, Forward report.” The invoices complied with the City’s billing requirements for describing attorney’s work. That bill would be the last detailed invoice submitted by the firm to the City.

Kroll senior officials sent a status report to the City Council on 10 June 2005. The report stated that Kroll employees had been working with Vinson & Elkins employees to gather information, coordinate with KPMG, communicate with law enforcement agencies, collect additional documents, and prepare correspondence with the SDCERS Board.

Representatives of Kroll and Willkie Farr appeared before the televised City Council meeting on 14 June 2005 to give a presentation on their progress and answer questions from City officials. At the meeting, Mr. Levitt told the City Council that Kroll’s work – which includes comparing the City Attorney and Vinson & Elkins investigations, writing and issuing an investigative report, and drafting remediation steps – would be completed

⁶² Source: Kroll Invoices from 30 March 2005, 5 April 2005, 5 April 2005, 18 April 2005, 27 April 2005, 9 May 2005, 20 May 2005, 3 June 2005. (Exhibit 45)

⁶³ Source: Kroll Invoices from 30 March 2005, 5 April 2005, 5 April 2005, 18 April 2005, 27 April 2005, 9 May 2005, 20 May 2005, 3 June 2005. (Exhibit 45)

⁶⁴ 17 May 2005. Willkie Farr & Gallagher bill to City of San Diego. (Exhibit 46)

before the end of the calendar year. Levitt said, “I would be very disappointed if I wasn’t out of here by the end of the year.”⁶⁵

At this point, Kroll had not provided any detailed billing or a written work plan. The lack of details in the Kroll invoices left the City unable to discern what, if any, work was being done. Neither Kroll nor Willkie Farr provided the City Council or the City Attorney with a work plan or schedule.

City Attorney asked Mr. Levitt at the 14 June 2005 televised City Council meeting if such a work plan could be drafted and delivered. Levitt said, “I see no reason why we can’t give you a written report on our action.”⁶⁶ To date, the City Attorney cannot confirm that an appropriate written work plan has been provided to the City. The City Attorney also requested that Kroll provide detailed billings of its work. That request was neither responded to nor observed in practice. The City Attorney has also referred the issue to the San Diego County Grand Jury.⁶⁷

On 22 June 2005, Willkie Farr submitted another bill to the City for \$232,725.⁶⁸ This bill, unlike the first bill from the Willkie Farr firm, included no details on the work being performed. The City failed to adhere to internal control standards when it did not require Willkie Farr to prepare the detailed billings.

One week later, on 24 June 2004, another bill from Kroll for \$194,194 was received by the City. The billing was broken into two classifications: “For Professional Services Rendered” and “Out-of-Pocket Disbursements.”

⁶⁵ Transcript of Arthur Levitt’s comments at the 14 June 2005 meeting of the San Diego City Council. (Exhibit 47)

⁶⁶ Transcript of Arthur Levitt’s comments at the 14 June 2005 meeting of the San Diego City Council. (Exhibit 48)

⁶⁷ 10 April 2006. Letter from San Diego City Attorney Michael J. Aguirre to the San Diego County Grand Jury. Re: San Diego City Attorney Requests Grand Jury to Expand Investigation of City of San Diego’s Use of Enterprise Funds to Pay for General Fund Costs. (Exhibit 106)

⁶⁸ 22 June 2005 Willkie Farr & Gallagher bill to City of San Diego. (Exhibit 49)

The billing included a list of 12 employees, their hourly rates and charges, but lacked any information about the work being performed.⁶⁹

At the 28 June 2005 meeting of the City Council, an item was docketed to allocate an additional \$708,825 to Kroll to proceed with their work on the investigation and perform background research on appointees to the SDCERS Board. The Council passed the item 8 to 0, with Council member Ralph Inzunza absent.⁷⁰ The next day, 29 June 2005, Kroll sent a bill to the City Council for \$236,281.⁷¹ The invoice was broken into “For Professional Services” and “Out-of-Pocket Disbursement.” Again, the bill included only names, hourly rates, and the total billed.

Kroll again appeared before the City Council on 9 August 2005, to provide another status report and to receive allocation of additional funds. Outlining work completed to date, Levitt said:

First, we have engaged in extensive dialogue with the City’s investigators at Vinson & Elkins and evaluated the extent of additional work necessary, so that the investigation may be brought to a conclusion. Second, we have met with the City’s outside auditors at KPMG, discussed with them at great length the investigative material and are in the process of implementing an agreed upon plan which at its conclusion would allow KPMG to issue an audit report on the City’s financial statements. Third, we have begun to work on remediation efforts including the removal of the retirement system’s actuary and working with a new City Auditor and controller who are appropriately improving internal controls. Fourth, we have organized and are overseeing the production of documents that both the SEC and the U.S. Attorney subpoenaed more than a year ago. Fifth, over the course of our work these last five months we’ve had several discussions and meetings

⁶⁹ 24 June 2005 Kroll invoice to P. Lamont Ewell. (Exhibit 50)

⁷⁰ 28 June 2005 meeting of the San Diego City Council. (Exhibit 51)

⁷¹ 29 June 2005 Kroll invoice to P. Lamont Ewell. (Exhibit 52)

with the independent auditors [KPMG] who support our approach and our efforts.⁷²

Levitt also stressed that the expected completion date for Kroll's work was December 2005.⁷³ At that meeting the Council approved the allocation of \$1.2 million for the Kroll investigation on a 6 to 0 vote.⁷⁴ At the meeting, the City Attorney displayed the Kroll billings and stated that without any line item detail, the City was unable to document what work had actually been completed.

That same day, 9 August 2005, the City Attorney wrote a memo to San Diego City Auditor John Torell seeking support to require detailed bills. The City Attorney wrote, "It is impossible for the Auditor to verify these amounts are justified without sufficient documentation. In order to protect taxpayers' monies, we request that the Auditor demand and review more detailed documentation before paying any further invoices."⁷⁵

In 2005, the County Grand Jury launched an investigation into the City of San Diego's alleged utilization of enterprise fund monies for general fund expenses. As a result, the County Auditor is currently performing an audit of City of San Diego financial records to determine if, in fact, money was illegally diverted from San Diego's Water and Wastewater enterprise funds to pay for general fund services.

The City Attorney believes these money diversion schemes have occurred and as a result of past management deficiencies may still be occurring due to a lack of management oversight.

⁷² Transcript of Arthur Levitt's comments at the 9 August 2005 meeting of the San Diego City Council. (Exhibit 53)

⁷³ Transcript of Arthur Levitt's comments at the 9 August 2005 meeting of the San Diego City Council. (Exhibit 53)

⁷⁴ Minutes for the San Diego City Council meeting on 9 August 2005. (Exhibit 54)

⁷⁵ 9 August 2005 memorandum from City Attorney Michael Aguirre to City Auditor John Torell. Carbon-copied to P. Lamont Ewell. Subject: Insufficiency of Documentation for Payments to Kroll and Willkie, Farr. (Exhibit 55)

On 11 August 2005 the City Attorney wrote another letter to Kroll officials requesting more detailed billings. The City Attorney wrote, “The City Attorney again requests that Kroll and its legal counsel provide detailed billings for all amounts thus far billed to or paid by the City of San Diego. Although such billings are required under applicable City contract provisions and policies, they have not been provided.”⁷⁶

The City Attorney issued another letter to Troy Dahlberg on 6 September 2005 requesting more detailed billings.⁷⁷ Officials at Kroll or Willkie Farr have not responded to either letter.

Kroll later sent a bill to the City on 23 September 2005, for a total of \$231,912. Despite the repeated requests from the City Attorney, the sole detail listed by Kroll for the work was “For Professional Services Rendered.”⁷⁸

Representatives of Kroll and Willkie Farr appeared before the televised City Council meeting on 26 September 2005 to provide an update on its progress. At the meeting, Benito Romano and Troy Dahlberg both said that detailed billings were not provided to the City because City Manager P. Lamont Ewell said it was not necessary. Dahlberg and Ewell both stressed that the City maintained the right to audit the work of Kroll and Willkie Farr at any time. During this conversation, the City Attorney said the City Manager does not hold the authority to relieve a consultant of the requirement to comply with the City’s billing guidelines or AICIPA requirements set forth in AU § 319.⁷⁹

At the meeting, the City Attorney asked Troy Dahlberg why detailed billings were not being provided. Dahlberg replied that the information was not included for three reasons. First, accountants don’t bill “that way.”

⁷⁶ 11 August 2005. Letter from City Attorney Michael Aguirre to Arthur Levitt, Troy Dahlberg, and Lynn Turner. (Exhibit 56)

⁷⁷ 6 September 2005 letter from City Attorney Michael Aguirre to Troy Dahlberg. (Exhibit 57)

⁷⁸ 23 September 2005 Kroll invoices to P. Lamont Ewell. (Exhibit 58)

⁷⁹ Transcript of the 26 September 2005 meeting of the San Diego City Council. (Exhibit 59)

Furthermore, Dahlberg stated that Kroll does not have the technology to compile the bills on a half-hourly basis. Dahlberg also said that the bills are vague to protect those being investigated. Dahlberg said:

We are basically accounting. I am an accountant, okay. We don't even have a system that does this. Attorneys bill that way. Accountants tend to bill more on tasks... We don't really have the billing records to set this up. It would be a titanic economic expense for us to do it... I've done lots of investigations before and we do not show in the investigation in the bills that we are doing the investigative work on because, unfortunately, there is sometimes a presumed level of guilt if you just look at somebody's stuff... When we did these kinds of investigations we never went into the kind of detail about whose e-mail we were looking at, whose documents we were looking at.⁸⁰

Mr. Dahlberg is both a certified public accountant and a lawyer. Another letter was sent by the City Attorney to Deputy Mayor Toni Atkins and City Council members on 24 October 2005, repeating the need for detailed billings to ensure that work is progressing. The letter states:

The City Attorney's Office has repeatedly requested all invoices for Kroll and Willkie Farr & Gallagher. Those requests have been met with resistance. The public's funds and confidence in government are seriously compromised by the practice of bypassing the City Attorney's Office to review these expenses. The Invoices submitted by Kroll for their work are wholly inadequate and contrary to best, let alone acceptable billing practices.⁸¹

Also on 24 October 2005, another Kroll bill was received by the City for a total of \$465,862.⁸² Despite the numerous request from the City Attorney for a line item accounting of what work was being done, the time

⁸⁰ Transcript of the 26 September 2005 meeting of the San Diego City Council. (Exhibit 59)

⁸¹ 24 October 2005. Letter from City Attorney Michael Aguirre to Deputy Mayor Atkins and City Council. (Exhibit 60)

⁸² 24 October 2005 Kroll invoice to P. Lamont Ewell. (Exhibit 61)

spent on each task, and which employee was completing the work, the bill arrived with no detail other than cost. More than \$1.5 million of Kroll's bills were accepted and paid by the City without itemization.

The first Kroll bill sent to the City included only a line item of tasks being worked and the costs of that work was delivered on 16 November 2005 for a total of \$685,408.⁸³ The City Attorney believes that these invoices are insufficient to meet the internal controls of the City because the individual employees' tasks and the number of hours spent on each task are not provided.

Under Kroll's new billing practices, the City remains unable to perform an accurate audit to ensure that the tasks listed are in fact being completed. Kroll submitted a series of 10 bills from 18 November 2005 through 16 March 2006 for a total of \$2,460,361⁸⁴. None of the billings included a detailed account of what task was being performed, by whom, or the time spent.

Willkie Farr also began submitting bills that included employee names, hours billed and their total costs. In a separate graphical matrix, the tasks that were being completed and the total costs of the tasks were listed. The firm submitted seven bills from 15 July 2005 through 30 January 2006 totaling \$3,550,446.⁸⁵

Over the course of the engagement, the City failed to require detailed billings from Kroll and kept no control over the nature, timing, quantity, or quality of the work completed.

⁸³ 16 November 2005 Kroll invoice to P. Lamont Ewell. (Exhibit 62)

⁸⁴ Kroll invoices to City of San Diego for 18 November 2005; 10 January 2006; 19 January 2006; 23 January 2006; 30 January 2006; 3 February 2006; 9 February 2006; 21 February 2006; 8 March 2006; and 16 March 2006. (Exhibit 63)

⁸⁵ Willkie Farr & Gallagher invoices to City of San Diego for 15 July 2005; 31 August 2005; 19 September 2005; 19 October 2005; 16 November 2005; 30 January 2006; and 7 March 2006. (Exhibit 64)

VI.

KROLL COMPROMISED ITS INDEPENDENCE

The most important -- and most frequently cited -- reason to hire Kroll Inc. and Willkie Farr & Gallagher was their independence. It was believed that the firms, having no ties to the City, would be able to conduct a thorough, proper investigation as provided by AU § 317.⁸⁶ The investigation was requested by KPMG and was deemed necessary to complete the City's 2003 CAFR. Kroll was specifically hired by the City in February 2005 to conduct an "independent assessment" of a series of separate reports produced by the City Attorney and Vinson & Elkins.⁸⁷

However, the relationship between Kroll and Vinson & Elkins was not independent. The City Attorney believes that Kroll appears to have overstepped the scope of the contracted work and this is particularly true with Kroll's oversight over the production of Vinson & Elkins' second report. Moreover, this has compromised the validity of any report ultimately released by Kroll.

The relationship between Kroll and former City Manager Lamont Ewell, Council members Scott Peters, Toni Atkins, and Jim Madaffer also raises questions about the firm's ability to conduct a fair, thorough, and honest investigation into illegal acts and alleged violations of law by City Officials. A series of e-mails recovered from the hard drive of Ewell illustrate that Kroll was engaged in activities expanding far beyond their contractual obligation.

As stated earlier in this report, Vinson & Elkins was directed to conduct a second, more detailed investigation after KPMG found the 16 September 2004 report to be insufficient. In July 2005, Vinson & Elkins issued a draft second report, submitted it to the representatives of Kroll⁸⁸,

⁸⁶ American Institute of Certified Public Accountants AU § 317 – Illegal Acts by Clients (Exhibit 6)

⁸⁷ 10 February 2005 letter from Troy Dahlberg to Mayor Richard Murphy. Re: Independent Services for the City of San Diego. (Exhibit 14)

⁸⁸ 15 July 2005. E-mail from Jennifer Arnini to Michael Young, Benito Romano, and Brian Turetsky. (Exhibit 65)

but did not release on the record to City Council or the City Attorney. Rather, in response to a series of questions by the City Attorney and Council member Donna Frye in August 2005, Troy Dahlberg admitted the existence of a draft copy and reluctantly turned it over to City officials.⁸⁹

The report found that the City did not adhere to proper accounting and financial disclosure practices on its CAFR. However, it concluded that no individuals knowingly violated any laws.⁹⁰ The report was discounted by KPMG and was widely considered to be another Vinson & Elkins “white wash”.

According to submitted invoices to the City by Vinson & Elkins, members of the Kroll team worked closely with representatives of Vinson & Elkins in organizing documents and drafting the second Vinson & Elkins report. Further evidence of the lack of independence between Kroll, V&E, and City officials – including City Council members – was found in Ewell’s e-mail box.

A. KROLL AND VINSON & ELKINS

A key element of the work to be performed by Kroll consisted of reconciling the reports of the City Attorney and Vinson & Elkins. This would necessarily mean that Kroll would and should be scrupulous in maintaining its independence from Vinson & Elkins. However, Kroll’s independence from Vinson & Elkins was compromised as early as April of 2005, according to invoices submitted by Vinson & Elkins, members of the Kroll team began working directly with Vinson & Elkins on preparing and drafting the Vinson & Elkins’ second report.

In late May, Richard Sauer, a partner at Vinson & Elkins, spent 10 hours working on a “Draft report regarding securities law violations.” During this time – between 24 May 2005 and 31 May 2005 – Paul Maco spent more than 30 hours meeting with Kroll representatives. Sauer then met with the Kroll team on 27 May 2005 for 5.50 hours for “team conferences” and “draft memo.” Maco then met with the Kroll team on 31 May 2005 for

⁸⁹ 1 August 2005 meeting minutes of the San Diego City Council.

⁹⁰ Vinson & Elkins draft report titled “Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals. 15 July 2005. (Exhibit 25)

2.5 hours to “continue report preparation.”⁹¹ The second report from Vinson & Elkins would not be released until August.

It is difficult to see how Kroll could maintain its objectivity and independence in the task for which it was retained by the City – the review, evaluation and comparison of the Vinson & Elkins and City Attorney reports – when Kroll was working directly with Vinson & Elkins in creating the firm’s follow-up report.

On 16 February 2005, Lynn Turner sent an e-mail to Ewell explaining that V&E would, in effect, report directly to Kroll. Turner wrote, “Lamont – just to let you know I had a good call with Paul Maco yesterday and was able to communicate with Les Hand who was in NYC. Paul and I set up a reporting arrangement whereby he will report to us...”⁹²

The message was sent just days after the City Council approved the letter of engagement with Kroll in February and months before V&E released its second report. The message clearly illustrated that V&E and Kroll were working closely since the beginning of Kroll’s work for the City.

The second report clearly failed to meet the requirements of AU § 317, which was explicitly required by KPMG in its earlier letters to the City. Neither of the investigative reports by Vinson & Elkins included an analysis of the computer hard drives of City Council members and their staffs, according to Paul Maco at the 9 August 2005 meeting of the City Council.⁹³

The second report also failed to properly track down information following the questioning of witnesses. Specifically, the report discussed the Mayor’s Blue Ribbon Committee on Finances report. Vinson & Elkins describes the report as, “The first significant warning as to the possible long-term consequences of the City’s attempts to minimize its contributions and reported liabilities to SDCERS came from a committee appointed by Mayor

⁹¹ 7 June 2005. Vinson & Elkins invoices to P. Lamont Ewell. (Exhibit 76)

⁹² 16 February 2005. E-mail from Lynn Turner to P. Lamont Ewell. Subject: SAn Diego. (Exhibit 77)

⁹³ Transcript of the 9 August 2005 meeting minutes of the San Diego City Council. (Exhibit 79)

Murphy to assess the City's long-term financial health.”⁹⁴ The Blue Ribbon Committee report was presented to the City Council's Government Rules and Finance Committee on 27 February 2002.⁹⁵

San Diego businessman Richard Vortmann was responsible for studying and writing the section of the Blue Ribbon Committee report focusing on the Pension system. Overseeing the work of Vortmann on the report were former City Auditor Ed Ryan and former Acting City Auditor Terri Webster. The second Vinson & Elkins report contains correspondence between Webster and Ryan illustrating repeated attempts to soften Vortmann's downcast financial assessment.

Vinson & Elkins and Kroll, however, did not adequately investigate the extent of the communications, whether other City officials directed Ryan and Webster, or examine the potential legal implications.

In the report, Vortmann correctly identified potential problems in the system including a growing liability for retiree medical care and the artificial health of the pension funded liability. Vortmann's report stated that, at the time, the funded ratio of SDCERS was 97 percent.

That information was inaccurate at the time of the presentation because the newest valuation for the SDCERS had been released to the Board on 12 February 2002 which pegged the unfunded liability at 89 percent. The 97 percent funded number represented financial information as of June 2000 while the 89 percent number reflected the newer figures as of June 2001.

Vortmann was a member of the SDCERS Board in the months immediately preceding the presentation of the Blue Ribbon Committee Report and was privy to the new valuation, but made no effort to include information before the hard copy of the report had been finalized and approved by the Committee. Vinson & Elkins interviewed Vortmann and Terri Webster, former acting auditor for the City of San Diego, who oversaw the production of the report, about the failure to include the new numbers.

⁹⁴ Vinson & Elkins draft report titled “Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals. 15 July 2005. P. 45-50. (Exhibit 80)

⁹⁵ 27 February 2002. Blue Ribbon Committee Report on City of San Diego Finances. (Exhibit 81)

In an interview with VINSON & ELKINS, Mr. Vortmann stated that he could not recall whether he received and read the FY 2001 actuarial report prior to the publication date of the Blue Ribbon Committee Report but, in any event, found that it simply confirmed his view that FY 2001 would bring further decline in funded level. Thus, in Mr. Vortmann's view, it did not materially affect the overall presentation of the report. Ms. Webster told V&E that she remembered some discussion among members of the Blue Ribbon Committee about including the updated number, but believes this was not done because, among other things, the actuary's report had not yet been accepted by the SDCER Board."⁹⁶

The Vinson & Elkins report, however, also included a letter that Vortmann had written on 18 February 2002 to Frederick Pierce IV, then president of the SDCERS Board, where the new actuarial valuation was discussed. Therefore, this information had been released, was discussed by Vortmann in a letter to Pierce, but was not included in the report. Vinson & Elkins and Kroll, who oversaw the writing, failed to adequately investigate why the information was not presented to the City Council Committee.⁹⁷

The City Attorney believes that the newest information showing the deteriorating financial health of the pension's funded ratio should have been included in the report as stated in the City Attorney's Second Interim Report.

The second report by Vinson & Elkins which Kroll oversaw also overlooked one of the most important pieces of evidence discovered in the course of the investigations: an e-mail exchange between Ed Ryan, Terri Webster, and two of the City's labor negotiators, Dan Kelly and Mike McGhee.

The topic of the correspondence is the "presidential benefit" that Ron Saathoff would receive as part of the Manager's Proposal II deal. Saathoff, at the time, was president of the San Diego Firefighters Union Local 145 and

⁹⁶ Vinson & Elkins draft report titled "Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals. 15 July 2005. P. 44-50. (Exhibit 80)

⁹⁷ Vinson & Elkins draft report titled "Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals. 15 July 2005. P. 44-50. (Exhibit 80)

also a member of the SDCERS Board. In short, the e-mail illustrates that Saathoff, the City, and the retirement board members were all aware that the boosting of retirement benefits was contingent upon the SDCERS Board allowing the City to underfund the pension. McGhee wrote to Ryan, Webster, and Kelley, "I assure you that Ron is well aware of the contingent nature of the benefits."⁹⁸ The City Attorney discussed the e-mail extensively in the Second Interim Report which was released on 9 February 2005.

This information, however, was not discussed in the second Vinson & Elkins report, the very report that Kroll oversaw. In fact, the report stated that no evidence existed to establish a quid pro quo or contingent arrangement in the passage of Manager's Proposal II. Vinson & Elkins wrote, "A link between MP2 and the Union Presidents' Resolution is not clearly established by the evidence available to us at this time. The San Diego District Attorney has charged Mr. Saathoff (and others) with a conflict of interest in voting in favor of MP2, in part due to an alleged link between that measure and the union presidents' benefit."⁹⁹

The complete failure to include this valuable piece of evidence in the assessment of illegal acts analysis, again, illustrates that Kroll's credibility to continue an investigation into the City has been irreparably compromised.

B. KROLL AND CITY OFFICIALS

Even before Kroll was hired by the City to "receive, review and evaluate the findings of the investigations by V&E and the City Attorney,"¹⁰⁰ Kroll officials were intimately involved in City business. City Manager Ewell sent an e-mail to Turner and Dahlberg on 2 February 2005 seeking information about the hiring of a new City Auditor.

⁹⁸ 21 May 2002 E-mail from Labor Relations officer Mike McGhee to Ed Ryan, city auditor; Terri Webster, assistant city auditor; and Dan Kelley, labor relations manager. (exhibit 82)

⁹⁹ Vinson & Elkins draft report titled "Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals. 15 July 2005. P 60-63. (Exhibit 83)

¹⁰⁰ 10 February 2005. Letter from Troy Dahlberg to Mayor Richard Murphy and San Diego City Council. Re: Independent Services for the City of San Diego. (Exhibit 14)

Ewell was in the process of interviewing John Torell and asked Turner and Dahlberg, “Should you have any knowledge of this person or reason to believe the City should not pursue hiring him, I would personally like to know. I will be negotiating employment terms with him this weekend. Sorry I failed to mention this during our conversation.”¹⁰¹ This was the first of many decisions in which Kroll would exceed the firm’s engagement with the City and compromise its independence from City officials.

More disturbing, Turner wrote an e-mail to Ewell on 17 February 2005 stating that “The SEC staff called this morning and asked if I would talk to them this afternoon. One thing I intend on doing during the telephone call with the SEC staff is to establish a good relationship and protocol with them.”¹⁰²

Turner went on to state that, “I will be telling them we should be viewed very much as an independent audit committee in this situation.”¹⁰³ Kroll exceeded its authority by dealing directly with the SEC. Not only did this exceed Kroll’s contractual mandate, but Kroll proceeded with the full the full knowledge of the city manager who offered no objection. Kroll was without the authority to communicate with the SEC on the City’s behalf.

Nonetheless, a representative of the SEC Pacific Regional office, followed the telephone conversation up with a letter to Turner on 23 February 2005 requesting a meeting to “better understand the processes you will undertake and the timeline for the completion of your work.” It also specifically recommended “that you include the Mayor, a representative of the City Council, the City Manager, City Attorney, and representatives of Vinson & Elkins and KPMG in the meeting to facilitate our complete understanding of the City’s objectives and undertakings with respect to your

¹⁰¹ 2 February 2005. E-mail from P. Lamont Ewell to Lynn Turner and Troy Dahlberg. Subject: “appointment of new Auditor.” (Exhibit 66)

¹⁰² 17 February 2005. E-mail from Lynn Turner to Leslie Girard and P. Lamont Ewell. Subject: “SEC Call.” (Exhibit 67)

¹⁰³ 17 February 2005. E-mail from Lynn Turner to Leslie Girard and P. Lamont Ewell. Subject: “SEC Call.” (Exhibit 67)

retention.”¹⁰⁴ Turner forwarded a proposed meeting time to Ewell and Dahlberg on 23 February 2005.

Kroll’s burgeoning working relationship with City Manager Ewell reveals that Kroll was failing to remain independent of the City Manager and was also moving closer to inappropriate entanglements with other City officials. On 24 February 2005, Turner e-mailed Ewell to discuss the City Council members – Scott Peters and Toni Akins – who Kroll has selected to attend a meeting with the SEC.¹⁰⁵

Turner and Ewell made the arrangements between themselves and the SEC; neither the public nor the City Attorney’s Office was involved. Kroll was becoming increasingly involved in decision making for which they had no mandate and that was not part of their contracted relationship with the City. Moreover, Kroll was inviting individuals into their ad hoc decision-making group who were, in part, the focus of the investigation. Not only was Kroll exceeding its authority but it was doing so in a way that indicates Kroll had no intention of drawing boundaries necessary to maintain independence.

The relationship between Turner and Ewell goes further. In a 23 April 2005 e-mail, Turner suggested that he could handle a phone call from one of the credit ratings agencies. Turner wrote to Ewell, “I know some of the people at Moody’s in the corporate governance area very well including Ken Bertsch and Greg Jonas. I would be very happy to take a call from Moody’s.”¹⁰⁶ The ratings agency had dropped the City’s credit rating in September 2004 from “Aa3” to “A1.”¹⁰⁷

¹⁰⁴ The City Attorney does not suggest this communication by the SEC was improper. (Exhibit 68)

¹⁰⁵ 24 February 2005. E-mail from P. Lamont Ewell to Lynn Turner. Subject: “Re: City Council Members” (Exhibit 70)

¹⁰⁶ 23 April 2005. E-mail from Lynn Turner to P. Lamont Ewell. Subject: “Re: Horribly Misquoted.” (Exhibit 71)

¹⁰⁷ Hall, Matthew. “Another credit rate downgrade announced.” *San Diego Union-Tribune*. 25 September 2004. (Exhibit 72)

Ewell replied that he would, “refer Moodies [sic] to you and will suggest that they call you as part of my presentation.”¹⁰⁸ The communication raises concerns that representatives of Kroll were using influence to lobby credit ratings agencies on behalf of the City of San Diego. This again raises significant concern over the company’s independence and ability to issue a truly “independent” investigative report.

Turner began including Council members Toni Atkins and Scott Peters on regular updates that were formerly the exclusive privilege of Ewell. Peters wrote an e-mail on 25 April 2005 to Ewell, Turner and Dahlberg stating, “I appreciated the call from Lynn recently explaining the next steps, and understand and support the retention of counsel [Willkie Farr & Gallagher]. I do feel a little out of the loop myself, however, especially on the schedule. I’d really appreciate a sense of where that is and what factor would affect it.”¹⁰⁹

The communication indicates that certain Council members, who were the subject of an illegal acts investigation, received updates on the status of the investigation. Peters, in the e-mail, also blurs Kroll’s line of independence by offering assistance and writes, “I am willing to do whatever I can to encourage the retirement board to release as many of the desired documents as possible.”

These e-mails clearly indicate a relationship between representatives of Kroll and certain members of the City Council that compromise Kroll’s ability to conduct an independent “illegal acts” investigation of City officials. The City Attorney believes that Council members who were the target of Kroll’s probe should not have received updates on the direction and status of the investigation.

The City Attorney believes that Kroll’s independence has also been compromised by working in conjunction with the offices of the Mayor and City Manager throughout the investigation. Both the offices are primary focuses of the investigation and both have played key roles in the production and management of documents.

¹⁰⁸ 23 April 2005. E-mail from P. Lamont Ewell to Lynn Turner. Subject: “Re: Horribly Misquoted.” (Exhibit 73)

¹⁰⁹ 25 April 2005. E-mail from Scott Peters to P. Lamont Ewell and Troy Dahlberg. Subject: “Audit Committee Issues”. (Exhibit 74)

The City Manager's office should not have been in the chain of custody of the documentary evidence in Kroll and Willkie Farr's investigation because employees of the City Manager's office were involved in the Manager's Proposal II in 2002 and other alleged illegal acts. A letter from the City's Chief Information Officer, Rey Arellano, to Lynn Turner on 23 June 2005 provides additional evidence that the City Manager's office played a key role in the collection, storage and disclosure of evidence important to the investigation.¹¹⁰

City Manager Lamont Ewell left the City of San Diego on 28 November 2005¹¹¹ and a new government system was instituted on 2 January 2006. As a result, two letters from Kroll and Willkie Farr have been sent to Mayor Jerry Sanders and Council member Scott Peters. The City Attorney believes that Council member Peters should not be included as a point of contact for the "independent investigators" because he is a subject of the investigation. Kroll's independence has been compromised because Ewell and certain of the Council members were directly involved in the alleged "illegal acts." Kroll was supposed to be reconciling the City Attorney's report finding substantial evidence that some council members had knowingly or recklessly violated federal securities fraud laws.

C. KROLL AND THE UNION-TRIBUNE

Kroll has also compromised its independence by stepping outside of its contractual obligations with the City by meeting on multiple occasions and engaging in lobbying activities with the editorial board of the San Diego Union-Tribune.¹¹² Coincidentally, the newspaper has issued a series of

¹¹⁰ 23 June 2005 letter from Rey Arellano, chief information officer for the City of San Diego, to Lynn Turner. (Exhibit 23)

¹¹¹ Lewis, Scott. "Longest Resignation Ever." *Voice of San Diego*. 28 November 2005. (Exhibit 98)

¹¹² The City Attorney finds it necessary to note that the newspaper did not act improperly when seeking comments and updates from high ranking consultants working for the City. The City Attorney believes the inappropriate acts occurred by representatives of Kroll and Vinson & Elkins who were without authority to conduct meetings with the press and charge the City for the time of said meetings.

editorial articles stressing the importance of paying Kroll and Willkie Farr millions of dollars.

Early in Kroll's work for the City, Ewell sent an e-mail on 3 March 2005 to Turner asking, "How do you feel about arranging a meeting with you and the Editor of the [Union] Tribune for Monday since you are here? It may help with the next days editorial, which will surely follow given the request of Council to sign the agreement."¹¹³ The agreement Ewell mentions is a letter that Turner asked City Council members to sign to "refrain from the personal criticism and accusation...whether it be in this Chamber, the press conferences...or elsewhere."¹¹⁴

This period was marked by a contentious atmosphere following the City Attorney's release of Interim Reports. The City Attorney believes this was an effort by Ewell to use Kroll to lobby the Union Tribune editorial board, a task that Kroll was not contractually authorized or permitted to engage in. An additional Ewell e-mail illustrates that Kroll for months lobbied the Union-Tribune editorial board and representatives of the San Diego Regional Chamber of Commerce, a local pro-business lobbying group.

More than one month later, Ewell received an e-mail from Turner outlining an update to Union Tribune editors stating,

"I did have a call today with Bill Osbourn updating him on our progress – I did tell him this was not going to be done quickly as he was asking for timing. I said we were committed to the thorough and comprehensive investigation that KPMG would require prior to signing off. Bill Kettle [Bob Kittle, director of the Union –Tribune editorial page] was on the other line and Bill was going to have him call me when I return from DC."¹¹⁵

¹¹³ 3 March 2005. E-mail from P. Lamont Ewell to Lynn Turner. Subject: "Re: Resolution/Letter for Council" (Exhibit 84)

¹¹⁴ 7 March 2005. San Diego City Council resolution R-300203 (Exhibit 17)

¹¹⁵ 12 April 2005. E-mail from Lynn Turner to P. Lamont Ewell. Subject: "Re: Update" (Exhibit 85)

Ewell continued to receive updates from Turner after conversations with the Union-Tribune editorial board. Turner sent an e-mail on 22 April 2005 stating, “Just got off the line with Kittle he seemed to understand what was going.”¹¹⁶ As evidenced by Ewell’s e-mails Turner was also updating other members of the community. In a 24 April 2005 e-mail to Ewell, Turner wrote, “In addition to talking to the press, I have also alerted the Chamber as to current events as well as the two council members who are our contacts.”¹¹⁷

At this time, a series of articles touting the City’s need for Kroll appeared in the Union-Tribune editorial pages. The first article was a question and answer session between representatives of Kroll, Willkie Farr, and the Union-Tribune editorial board. According to the article, printed on May 15, 2005¹¹⁸, Levitt said about the timing of the investigation:

I think this project calls for a resolution by the end of the year. I don’t know very much about whether it’s a million or two million or exactly what the number is.¹¹⁹

Turner, who was also present at the meeting, echoed Levitt’s timing estimates. Turner said, “We’ve got to be there by the end of the year.”¹²⁰ The next Union-Tribune editorial appeared on 11 August 2005 and provided a more forceful endorsement for Kroll. The Union-Tribune editorial board wrote:

The indispensable key to getting the city back on its feet financially is the three-member audit committee chaired by

¹¹⁶ 22 April 2005. E-mail from Lynn Turner to P. Lamont Ewell. Subject: “Re: Just got off the line with Kittle” (Exhibit 86)

¹¹⁷ 24 April 2005. E-mail from Lynn Turner to P. Lamont Ewell. Subject: “Re: Horribly Misquoted.” (Exhibit 87)

¹¹⁸ 15 May 2005. “Q&A: Lynn Turner, Arthur Levitt, Benito Romano.” *San Diego Union-Tribune*. (Exhibit 88)

¹¹⁹ 15 May 2005. “Q&A: Lynn Turner, Arthur Levitt, Benito Romano.” *San Diego Union-Tribune*. (Exhibit 88)

¹²⁰ 15 May 2005. “Q&A: Lynn Turner, Arthur Levitt, Benito Romano.” *San Diego Union-Tribune*. (Exhibit 88)

former Securities and Exchange Commission chairman Arthur Levitt. Operating with total independence, the panel is assisting KPMG, the city's outside auditor, in completing the stalled financial statements that have locked San Diego out of capital markets for over a year... This probe is instrumental to both the SEC's anticipated enforcement action against the city and U.S. Attorney Carol Lam's criminal investigation... Without the independent oversight provided by the audit committee, all of San Diego's efforts to regain its financial strength would collapse in one catastrophic stroke...If Aguirre is incapable of becoming part of the solution, he at least must stop obstructing those who are committed to moving San Diego forward responsibly.¹²¹

The Union-Tribune editorial board wrote the editorial in August and to date the City has received no work product from Kroll. Arthur Levitt also submitted an op-ed piece for publication in the San Diego Union-Tribune which was printed on 11 August 2005.¹²² It is unclear, in light of any details in the billings, if the City was billed for the placement of the op-ed that advocated the necessity of retaining Kroll.

Representatives of Kroll appeared before the televised City Council meeting on 1 November 2005. When questioned by City Council members, Troy Dahlberg admitted to meeting with the editors of the San Diego Union Tribune and billing the City for that time.¹²³ Representatives of Kroll have also billed the City for meeting with the San Diego Regional Chamber of Commerce and The Wall Street Journal.¹²⁴

The Union-Tribune editorial board provided another glowing recommendation of Kroll just days after new Mayor Jerry Sanders' took

¹²¹ 11 August 2005. "Aguirre's Gambit." *San Diego Union-Tribune*. (Exhibit 89)

¹²² Levitt, Arthur. "Reviving San Diego: Looking at the numbers at City Hall." *San Diego Union-Tribune*. 11 August 2005 (Exhibit 90)

¹²³ Transcript of the 1 November 2005 meeting of the San Diego City Council. (Exhibit 91)

¹²⁴ Christensen, Kevin. "City's audit Mired in billing controversy." *The Daily Transcript*. 1 November 2005. (Exhibit 92)

office. The editorial, released on 13 December 2005, challenged the Mayor to pay Kroll additional monies and, again, touted Kroll leaders' job qualification. The Union-Tribune editorial board wrote:

The keystone of San Diego's financial recovery is its independent audit committee. The city's ability to borrow money, issue certified financial statements and conduct a range of other essential business – not to mention get out from under the cloud of multiple federal probes – all hinges on the completion of the audit committee's investigation... Yet, astonishingly, the panel is on the brink of shutting down because of an interruption in its funding from the city.¹²⁵

The editorial acknowledges Mayor Jerry Sanders was apprehensive about paying the company another \$14 million without a guarantee that the work would be completed or that a timeline for completion be provided. The Union-Tribune editorial board took aim and fired at Sanders' request in the editorial:

Mayor Jerry Sanders and the City Council must move quickly to avert this looming calamity.... The urgent solution here is for Mayor Sanders to reach an ironclad funding agreement with the audit committee that is satisfactory to KPMG in terms of the scope and duration of the investigation. Then Sanders must present the matter to the City Council as soon as possible... San Diego's fiscal upheaval demands strong, determined direction from the top. This all-important issue poses the first critical test of Jerry Sanders' leadership.¹²⁶

While the City Council agreed on 17 January 2006 to provide Kroll with an additional \$10 million of funding, Kroll would not agree to any commitment to complete its investigations.

Rather, the e-mails, testimony and articles provide evidence that representatives of Kroll engaged in lobbying activities to apply political

¹²⁵ 13 December 2005. "Sanders' first test: Audit committee's probe must continue." *San Diego Union-Tribune* (Exhibit 93)

¹²⁶ 13 December 2005. "Sanders' first test: Audit committee's probe must continue." *San Diego Union-Tribune* (Exhibit 93)

pressure on City Hall to continue to pay bills without providing any evidence that work was being completed. The City Attorney believes that engaging in such activities compromises Kroll's ability to perform an independent investigation for the City.

D. KROLL AND KPMG

Kroll compromised its independence in its investigation into illegal acts in the City by defending KPMG which is concurrently working on the audit of the City's 2003 CAFR. On Monday, 29 August 2005, KPMG reached a preliminary agreement to pay \$456 million to settle charges brought by the federal government alleging the company created a tax shelter scheme defrauding more than \$1 billion from United States taxpayers.

The settlement, commonly referred to as a "consent decree," essentially admitted that the company was in violation of federal law and allowed the company to avoid potentially crippling charges in court. Meanwhile, the federal government prosecuted nine executives, who were removed from the firm.

When news of the settlement reached the national and international media, concerns were raised by KPMG's clients about the independence and credibility of the firm's work, specifically its audits. The Wall Street Journal and other international media outlets -- such as the British Broadcasting Corporation -- all issued news reports on the event. William Morris, western region director for KPMG, noted the concerns that clients had as a result of the settlement in the 12 September 2005 meeting of the San Diego City Council.¹²⁷ Morris said, "We took the matter extremely serious. We recognized it had ramifications to our firm, both our people and our clients. It was a serious matter and that we wanted it to be resolved."¹²⁸ The City Attorney believes that representatives of Kroll Inc. further compromised its independence in the investigation of the City of San Diego by defending KPMG in media reports.

¹²⁷ Transcript of the 12 September 2005 meeting of the San Diego City Council. (Exhibit 94)

¹²⁸ Transcript of the 12 September 2005 meeting of the San Diego City Council. (Exhibit 94)

In order for the audit of the 2003 CAFR by KPMG and the investigation by Kroll to be credible, each must maintain its complete independence. That independence includes the two firms being independent from one another. By vouching for KPMG Levitt and Turner created the appearance that KPMG was indebted to them. In turn KPMG has insisted that the City continue paying Levitt and Turner as a condition for KPMG issuing its opinion on the City's 2003 financial statement. Levitt and Turner helped KPMG keep its clients and KPMG helped Levitt and Turner keep the City of San Diego as a client. The public perception is that one hand was washing the other.¹²⁹

In the article, Levitt was identified as the heading the City of San Diego's audit committee. Levitt in that capacity, without prior approval from the City Council or City Attorney vouched for KPMG:

I think the audit clients will stand by them, because as they survey the field, the alternatives are certainly no better, and hopefully KPMG has moved strenuously to correct the problems of the past.¹³⁰

Levitt was cited as the "former Securities and Exchange Commission Chairman...who leads a committee supervising KPMG's audit of the city of San Diego finances." Lynn Turner was also quoted in the story and cited as "another member of the San Diego audit committee." In the ensuing months, the leadership of KPMG consistently defended the independence of the Kroll firm and promoted their competence and importance in the completing of an investigation into the City of San Diego meeting the guidelines of the AU § 319.

KPMG issued a letter on 22 September 2005 specifically promoting the use of Kroll. DeVetter stated,

¹²⁹ Weil, Jonathan. "KPMG's Settlement Provides for New Start: Agreement With U.S. Prosecutors Avoids Criminal Indictment; Civil, Class-Action Suits Remain." *The Wall Street Journal*. 29 August 2005. (Exhibit 95)

¹³⁰ Weil, Jonathan. "KPMG's Settlement Provides for New Start: Agreement With U.S. Prosecutors Avoids Criminal Indictment; Civil, Class-Action Suits Remain." *The Wall Street Journal*. 29 August 2005. (Exhibit 95)

KPMG continues to believe that it is important to the completion of the independent investigation that Messrs. Turner, Levitt and Dahlberg continue to take any and all actions they deem necessary or appropriate to satisfy their obligations under the terms of their retention by the City of San Diego.¹³¹

That same day, 22 September 2005, the Union-Tribune issued its third editorial article supporting the retention of Kroll and Willkie Farr.

VII.

KROLL EXCUSES FOR DELAY NOT VALID

Along with working on investigations, Vinson & Elkins was also hired to represent the City before the SEC. Part of this responsibility included assisting in document production in response to SEC subpoenas.

In order to make the documents production more efficient, Vinson & Elkins had been using an electronic discovery system product from NTI Breakwater for placement in a database, or documents repository, maintained by Applied Discovery, a subsidiary of Lexis-Nexis.

The City e-mail system is run off of a program called GroupWise, made by the Novell Inc. The hardware is proprietary and cannot be viewed on some computer programs.

Vinson & Elkins employed the NTI Breakwater product to convert the GroupWise documents to a file that can be opened and viewed by other computer programs for KPMG and federal investigators.¹³² The files converted by NTI Breakwater were then placed in an electronic depository, or database, operated by Applied Discovery. KPMG and federal investigators were then given access to the Applied Discovery database where the documents were stored. In this database, the documents could be opened and viewed.

¹³¹ 22 September 2005. Letter from Steven G. DeVetter to Acting Mayor Toni Atkins. Re: City of San Diego Fiscal Year 2003 Financial Statements Audit – Status Update. (Exhibit 96)

¹³² 22 November 2004. City of San Diego consulting engagement agreement with NTI Breakwater. (Exhibit 99)

As early as January 2005, officials at Applied Discovery, KPMG and Vinson & Elkins realized that some of the attachments to documents were not being converted and placed into the database. In other words, if an e-mail, or “parent,” had an attachment, or “child,” the parent would appear in the Applied Discover database but the child was missing. Kelli Clark, an account manager at Applied Discovery, spotted the issue and forwarded information in an e-mail:

I had our production team look into doc 206722 at KPMG’s request. When our team looked at the pre-converted document, the links to the attachments were ‘dead’. Hence, the attachments are not extracted and linked to the e-mail on the ORA. Additionally, when we look at doc #125481 (the number of the attachment that you provided today) there is no evidence that this document is an attachment to any other doc in the system.¹³³

Investigators at the SEC had realized this to be an issue early on, according to an e-mail sent from Ben Lippard, an attorney at Vinson & Elkins to Paul Maco. Lippard wrote:

There was only one issue of any real importance on the call today – the SEC was concerned about the fact that from applied discovery database you can’t tell which file attachments belong to which emails. I have instructed Kelli to consult with Anton about a technical fix to this issue, which it seems likely they will insist on.¹³⁴

This was a problem because the SEC and KPMG had both repeatedly asserted the need to see all documents requested to ensure that alleged improprieties that landed the city in its current financial difficulties would not happen again. If some of the e-mails and other electronic documents were not available, the investigation could not be adequately completed.

¹³³ 10 January 2005. E-mail from Kelli Clark to Ben Lippard. (Exhibit 100)

¹³⁴ 8 February 2005. E-mail from Ben Lippard to Paul Maco. Carbon-copied to Rick Sauer and William Lawler. Subject: Update on SEC call. (Exhibit 101)

The problem was solved by Applied Discovery and NTI Breakwater on 2 May 2005 and a solution was presented to KPMG and the SEC in May. Kelli Clark wrote, “Ok. FYI – I just got word from our tech department that the family groups work is complete now. Whenever you give the go ahead, we are ready to begin the transfer.”¹³⁵

City Manager Lamont Ewell released a memo on 8 September 2005 stating that Vinson & Elkins had failed to review more than 57,000 files of the 160,000 relevant documents.¹³⁶ Ewell wrote that technology had broken down and blamed Vinson & Elkins for overseeing the maintenance of the issue. Ewell wrote:

The failure to include these files on the database has delayed the City’s production of documents to the SEC and the United States Attorney’s office. In addition, this error has caused the City to incur significant costs in having the missing files restored, and costs associated with a complete review of emails required by the Audit Committee, in addition to the attorneys’ fees and expenses associated with creating and reviewing the original database.

It is my belief that V&E [Vinson & Elkins] was responsible for providing instructions to and supervising the work of ADI as part of its investigation and report to the City on disclosure matters.¹³⁷

The next day the Vice President of Applied Discovery issued a letter to Lamont Ewell on 9 September 2005 stating that the problems had been identified in January and corrected in June.¹³⁸ Nagel stated that the staff of Applied Discovery had notified the City that the problems were corrected

¹³⁵ 2 May 2005. E-mail from Kelli Clark to Ben Lippard. Subject: RE: Transfer of data to a new database for the SEC. (Exhibit 102)

¹³⁶ 8 September 2005 letter from City Manager P. Lamont Ewell to Paul Maco, partner for Vinson & Elkins. (Exhibit 103)

¹³⁷ 8 September 2005 letter from City Manager P. Lamont Ewell to Paul Maco, partner for Vinson & Elkins. (Exhibit 103)

¹³⁸ 9 September 2005. Letter from Scott Nagel, vice president of Applied Discovery, to P. Lamont Ewell. (Exhibit 104)

and that the City did not want the corrections implemented. Specifically, Nagel wrote that the City ordered the corrections not to be implemented. Nagel wrote:

Upon discovery of this issue in January, ADI offered to resolve the issue. At the time, ADI was told that the resolution it offered was unnecessary for purposes of the review work being performed. Later, in the April/May timeframe, ADI was asked to resolve part of the issue that had been created (i.e., repairing links between documents already in the database) for purposes of preparing a production database for the City. ADI did so, and also offered to resolve the remainder of the issues (i.e., ensuring that all family members of relevant documents were also included in the database) by re-running searches on the City's behalf. ADI was told not to re-run the searches.¹³⁹

Just days later, an item appeared before the San Diego City Council to allocate \$727,500 to hire consulting firm Electronic Database Discovery to build a second database for the storage of electronic documents obtained by the Kroll and Willkie Farr in its work. In September 2005, representatives of Kroll notified the City Manager of difficulties converting documents from the GroupWise system to an electronic format compatible with programs used by federal investigators.

The City at this point, however, had been experiencing the same problem. Despite the fact that NTI Breakwater and Applied Discovery – both of whom billed the City – solved the problem, the City's troubles persisted.

Representatives of Kroll and Willkie Farr submitted a letter to the City Council on 25 October 2005 stating that the problems with converting the electronic files properly will cause a delay in the completion of the investigation. The date was pushed from end of calendar year 2005 to mid-March 2006.

¹³⁹ 9 September 2005. Letter from Scott Nagel, vice president of Applied Discovery, to P. Lamont Ewell. (Exhibit 104)

The City Council also allocated another \$272,300 to increase the size of the database from 160 gigabytes to 240 gigabytes – enough to store 12 million pages of documents.¹⁴⁰

The City Attorney finds that problems with the conversion of the files from GroupWise should have been avoided. The City Attorney also finds that the hiring and continued funding for another electronic database company is a tactic to delay the completion of the investigation and an unnecessary drain on the City's coffers.

VIII.

CONCLUSION

Based upon the facts and circumstances set forth in this report it is the San Diego City Attorney's considered judgment that the City should forth with terminate Kroll and Willkie Farr and take all appropriate legal action to recover all damages proximately caused by Kroll and Willkie Farr's breach of duties owed to the City of San Diego.

By _____
Michael J. Aguirre
City Attorney

¹⁴⁰ Hall, Matthew T. "Investigators get e-mail database: City OKs money to expand system in pension probe." *San Diego Union-Tribune*. 21 December 2005. (Exhibit 105)